

Before the
POSTAL REGULATORY COMMISSION
WASHINGTON, D.C. 20268-0001

Rate and Service Changes to Implement)	
Functionally Equivalent Negotiated)	Docket No. MC2007-4
Service Agreement With The Bradford Group)	

INITIAL BRIEF OF THE
OFFICE OF THE CONSUMER ADVOCATE
(January 16, 2008)

The Postal Service has requested Commission approval of a Negotiated Service Agreement (“NSA”) with the Bradford Group.¹ The standards for approval of this NSA can be found in the Commission’s opinions in the Bank of America and Bookspan NSAs. The NSA at issue in this proceeding fails to meet those standards.

I. THE BRADFORD GROUP NEGOTIATED SERVICE AGREEMENT MUST SATISFY ONE OF TWO STATUTORY STANDARDS ESTABLISHED IN THE POSTAL ACCOUNTABILITY AND ENHANCEMENT ACT; NEITHER STANDARD HAS BEEN MET

With enactment of the Postal Accountability and Enhancement Act (PAEA), the Postal Service and Commission entered a new era with respect to the consideration and evaluation of negotiated service agreements. The Bradford Group negotiated service agreement (NSA) is the second agreement to be considered subsequent to enactment of the PAEA. The first NSA to which the policies and objectives of the

¹ See “Request of United States Postal Service for a Recommended Decision on Classifications and Rates to Implement a Functionally Equivalent Negotiated Service Agreement with Bradford Group”), August 3, 2007.

PAEA were applied by the Commission was the negotiated service agreement with Bank of America (BAC).

In its recommended decision on the Bank of America NSA, the Commission concluded that:²

[T]he enunciated policies and objectives of [the PAEA] are both material and relevant, and that they should be applied under the aegis of “such other factors as the commission deems appropriate. §§ 3622(b)(9) and 3632(c)(6).

As a “clear Congressional expression of public policy,”³ the PAEA recognizes the desirability of special classifications that improve the net financial position of the Postal Service or enhance Postal Service operations. More specifically in this regard, negotiated service agreements must:

- (A) either—
 - (i) improve the net financial position of the Postal Service through reducing Postal Service costs or increasing the overall contribution to the institutional costs of the Postal Service; or
 - (ii) enhance the performance of mail preparation, processing, transportation, or other functions;

Applying these statutory tests, the Commission found that the Bank of America NSA would not improve the net financial position of the Postal Service:⁴

The Commission estimates that the Postal Service will realize less net contribution as a result of entering into this Agreement than it would have without the Agreement.

² PRC Op. MC2007-1 (Bank of America Opinion and Recommended Decision), at 52.

³ *Id.*

⁴ *Id.*, at 50. However, the Commission observed that, “The net reduction in contribution as a result of proceeding with the Negotiated Service Agreement does not significantly reduce the overall level of contribution provided by BAC’s mail.” *Id.*, at 42.

In addition, the Commission gave consideration to potential, but unquantified, operational benefits flowing from the NSA, which provided incentives to encourage BAC to improve the processing and quality of its mail, and served to promote use of other advanced mail processing systems. The Commission concluded:⁵

To the extent that it achieves these objectives, the Agreement should enhance “the degree of preparation of mail for delivery into the postal system performed by the mailer” and have a positive “effect upon reducing costs to the Postal Service.” § 3622(b)(6).

These are the only considerations expressed by the Commission that could “help mitigate the adverse financial impact” of the net loss in contribution, and led the Commission to recommend the Bank of America NSA.⁶

Unlike the Bank of America NSA, however, the Bradford Group NSA lacks any incentives that would cause the Bradford Group to improve postal operations. Nor does the NSA contain other features that prompt more generalized improvements. Moreover, the Postal Service cannot identify any enhancements to postal operations that would satisfy the PAEA’s second statutory test and justify Commission recommendation of the Bradford Group NSA. Consequently, the PAEA’s first statutory test, which requires that an NSA improve the net financial position of the Postal Service, is alone applicable to the Bradford Group NSA.

OCA submits that the Bradford Group NSA cannot satisfy the first statutory test, and therefore is not a desirable special classification worthy of recommendation by the Commission. As explained in more detail below, the Postal Service has not

⁵ *Id.*, at 51.

⁶ *Id.*

demonstrated on this record, and cannot show, that the Bradford Group NSA will improve the net financial position of the Postal Service.

II. THE POSTAL SERVICE DID NOT AND CANNOT SHOW THAT THE BRADFORD GROUP NEGOTIATED SERVICE AGREEMENT WILL IMPROVE THE NET FINANCIAL POSITION OF THE POSTAL SERVICE

As designed, the Postal Service's financial model cannot be used to show that the Bradford Group NSA will improve the net financial position of the Postal Service. The Postal Service's financial model fails to acknowledge or control for the effects of non-price exogenous factors on the Bradford Group's eligible Standard Mail volumes, which in turn produces an estimate of the financial value of the agreement that is overly optimistic.

A. The Postal Service's Financial Model Does Not Acknowledge, or Control for, the Effect of Non-Price Exogenous Factors in Changing Demand for Standard Mail Letters and Flats

The Postal Service presents its financial model for the Bradford Group NSA in Appendix A of the testimony of witness Broderick Parr (USPS-T-1).⁷ As in all previous NSAs, the Postal Service accepts without change the point volume estimates of the Bradford Group by incorporation of such estimates into its financial model.⁸ However, those point volume estimates are affected by non-price exogenous factors including, among others, changes in corporate financial goals or marketing strategies.⁹ Such goals and marketing strategies, and the decisions underlying them, are not transparent

⁷ Testimony of witness Parr (USPS-T-1), Appendix A.

⁸ Compare testimony of witness Gustafson (BG-T-1), Table 1, at 8, and testimony of witness Parr (USPS-T-1), Appendix A, page 2.

⁹ Tr. 2/24 (OCA/USPS-T1-6(a)-(c)).

to the Postal Service. As a result, the effect of those decisions on point volume estimates cannot be replicated by the Postal Service. This, in turn, prevents the Postal Service from isolating discount induced volume from volume caused by such exogenous factors inherent in the Bradford Group's point volume estimates.

Moreover, the Postal Service's financial model as introduced assumes that the NSA's price incentives are solely responsible for any increase in the Bradford Group's volumes that exceed the before-rates volume forecast during the three-year term of the agreement.¹⁰ Acceptance of this assumption permits the Postal Service to estimate discounts "paid" to the Bradford Group and to calculate the net contribution. However, the Postal Service fails to acknowledge the existence of non-price exogenous factors inherent in the Bradford Group's point volume estimates incorporated into its financial model. Nor has the Postal Service controlled for the effects of non-price exogenous factors, as it did not obtain from the Bradford Group an elasticity of demand.¹¹ Nor did the Postal Service rely on an elasticity of demand specific to the Bradford Group for use in its financial model.¹² Only through the use of an elasticity of demand specific to the Bradford Group can a realistic estimate of the net contribution to the Postal Service be derived for volumes attributable to the NSA's discounted rates, rather than non-price exogenous factors. Nevertheless, the effect of non-price exogenous factors on the net contribution of the Postal Service can be presented using the Postal Service's financial model shown in Appendix A.

¹⁰ Tr. 2/35 (OCA/USPS-T1-15).

¹¹ Tr. 2/2-23 (OCA/USPS-T1-4-5).

¹² Tr. 2/34 (OCA/USPS-T1-14(c)).

Accompanying the financial model is Appendix C, Table 1, entitled “Value to Volume Sensitivity Matrix, Based on Year 1,” which displays results from the financial model that show the effect on net contribution of changing letter volumes by assuming that “actual” before-rates and after-rates letter volumes vary from the letter volume forecasts of 146.5 million and 168.0 million, respectively. For example, as shown in Appendix C, Table 1, below, where the difference between the “actual” before-rates and after-rates letter volumes and the letter volumes forecasts is 0 percent, the net contribution to the Postal Service is \$1.9 million, the Year 1 net contribution estimated by the financial model. Appendix C, Table 1 also displays the effect on net contribution (in millions) where the “actual” before-rates and after-rates letter volumes vary by different percentages above and below the letter volume forecasts, assuming there is no change in flats volumes.

Appendix C
Value to Volume Sensitivity Matrix
Based on Year 1

Table 1:

			After Rates Letter Volume						
Volumes (millions)			154.0	161.3	164.6	168.0	176.4	184.8	195.0
% Change			(8.3%)	(4.0%)	(2.0%)	0.0%	5.0%	10.0%	17.3%
Before Rates Letter Volume	102.6	(30.0%)	\$ 4.8	\$ 5.3	\$ 5.6	\$ 5.8	\$ 6.3	\$ 6.8	\$ 7.4
	117.2	(20.0%)	\$ 3.5	\$ 4.0	\$ 4.3	\$ 4.5	\$ 5.0	\$ 5.5	\$ 6.1
	131.9	(10.0%)	\$ 2.2	\$ 2.7	\$ 3.0	\$ 3.2	\$ 3.7	\$ 4.2	\$ 4.8
	146.5	0.0%	\$ 0.9	\$ 1.5	\$ 1.7	\$ 1.9	\$ 2.4	\$ 2.9	\$ 3.5
	161.2	10.0%	\$ (0.3)	\$ 0.2	\$ 0.4	\$ 0.6	\$ 1.2	\$ 1.6	\$ 2.2
	175.8	20.0%	\$ (1.6)	\$ (1.1)	\$ (0.9)	\$ (0.7)	\$ (0.1)	\$ 0.4	\$ 0.9
	190.5	30.0%	\$ (2.9)	\$ (2.4)	\$ (2.2)	\$ (2.0)	\$ (1.4)	\$ (0.9)	\$ (0.3)

Below is an extract from Appendix C, Table 1, presenting the change in net contribution (in millions) to the Postal Service caused by changing the “actual” after-rates letter

volume by the stated percentages above or below the letter volume forecast of 168.0 million, only for one row—the “Before Rates Letter Volume” row of 146.5 million.

Appendix C
Value to Volume Sensitivity Matrix
Based on Year 1

Table 1:

			After Rates Letter Volume						
Volumes (millions)			154.0	161.3	164.6	168.0	176.4	184.8	195.0
% Change			(8.3%)	(4.0%)	(2.0%)	0.0%	5.0%	10.0%	17.3%
Before Rates Letter Volume	146.5	0.0%	\$ 0.950	\$ 1.460	\$ 1.689	\$ 1.912	\$ 2.441	\$ 2.932	\$ 3.518

Using the same percentage changes in letter volume presented in Appendix C, Table 1, the effect on net contribution can be estimated by assuming the changes in volume are caused by non-price exogenous factors rather than the NSA's discounts. In the Postal Service's financial model, this assumption is implemented by removing the Year 1 contribution estimated for letters.¹³

OCA Exhibit 1, below, entitled “Value to Volume Sensitivity Matrix Assuming After Rates Letter Volume Caused by Non-Price Factors, Based on Year 1,” shows the net contribution to the Postal Service during Year 1 of the NSA, resulting from Postal Service “payment” of discounts to the Bradford Group and receipt of contribution where the various “actual” After Rates Letter Volume (i.e., 154.0 million, 161.3 million, 164.6 million, 168.0 million (the after rates letter volume forecast), 176.4 million, 184.8 million, or 195.0 million) is caused by non-price factors rather than the price incentives of the

¹³ Tr. 2/61 (OCA/USPS-T1-36(b)).

NSA. This contribution received is not “new” as it cannot be attributed to the price incentives of the NSA.¹⁴

OCA Exhibit 1
Value to Volume Sensitivity Matrix
Assuming After Rates Letter Volume Caused by Non-Price Factors
Based on Year 1

			After Rates Letter Volume						
Volumes (millions)			154.0	161.3	164.6	168.0	176.4	184.8	195.0
% Change			(8.3%)	(4.0%)	(2.0%)	0.0%	5.0%	10.0%	16.1%
Before Rates Letter Volume	146.5	0.0%	\$ 289,737	\$ 159,137	\$ 91,937	\$ 19,737	\$ (190,263)	\$ (439,263)	\$ (745,263)

As displayed in OCA Exhibit 1, the introduction of non-price exogenous factors into the Postal Service’s financial model causes financial risks to the Postal Service to explode. This is evident by comparing net contribution shown in the extract of Appendix C, Table 1 with OCA Exhibit 1, where the “actual” After Rates Letter Volume of 168 million equals the after-rates volume forecast (i.e., a 0% change between the actual After Rates Letter Volume and the after-rates volume forecast). As shown in Appendix C, Table 1, where the “actual” After Rates Letter Volume of 168.0 million is discount induced, the net contribution to the Postal Service is \$1.9 million (\$1,912,053). As shown in OCA Exhibit 1, where the “actual” After Rates Letter Volume of 168.0 million is caused by non-price exogenous factors, the Postal Service’s net contribution is \$19,733—a reduction of \$1,892,320 (\$1,912,053 - \$19,733).

The Summary Table, below, entitled “Reduction in Postal Service Net Contribution Assuming After Rates Letter Volume Caused by Non-Price Factors,”

¹⁴ Tr. 2/69 (OCA/USPS-T1-42(k)).

shows the reduction in net contribution at each of the various “actual” After Rates Letter Volumes.

Summary Table
Reduction in Postal Service Net Contribution
Assuming After Rates Letter Volume Caused by Non-Price Factors
(Millions)

After Rates Letter Volume (Millions)						
154.0	161.3	164.6	168.0	176.4	184.8	195.0
(8.3%)	(4.0%)	(2.0%)	0.0%	5.0%	10.0%	16.1%
\$ 0.660	\$ 1.301	\$ 1.597	\$ 1.892	\$ 2.632	\$ 3.371	\$ 4.264

As shown in the Summary Table, the reduction in net contribution to the Postal Service increases as the “actual” After Rates Letter Volume increases for all letter volumes above the lowest discount threshold up to 195.0 million—the volume cap for the NSA. Moreover, the effect of non-price exogenous factors causes a reduction in the net contribution to the Postal Service even where the “actual” After Rates Letter Volume is less than the after-rates volume forecast of 168.0 million.

The Postal Service maintains that the introduction of non-price exogenous factors into its financial model is “conceptually flawed.”¹⁵ The Postal Service’s financial model:¹⁶

is designed to use a before-rates and after-rates forecast which differ only by the volume effect of the proposed price change (in this case, the discounts on offer). Under these procedures, all other factors are assumed to be identical in the before-rates and after-rates forecasts. In a case where the assumed change due to price is zero, therefore, the before-rates and after-rates forecasts should be identical, and any assumed difference in a non-price factor should be represented as an identical change to both the before-rates forecast and the after-rates forecast.

¹⁵ Tr. 2/73 (OCA/USPS-T1-43(f)).

¹⁶ Tr. 2/73-74 (OCA/USPS-T1-43(f)).

The Postal Service obfuscates the effect of the introduction of non-price exogenous factors into its financial model. However, by shifting focus from changes in volumes between before-rates and after-rates induced by discount to changes in actual volumes caused by non-price exogenous factors, the financial model shows there is a reduction in net contribution to the Postal Service—irrespective of the before-rates volume forecast.

The controlling factor determining the net contribution to the Postal Service is the NSA contract, where actual volumes are assumed upon implementation of the NSA. In Year 1 (and Years 2 and 3), the Postal Service will “pay” discounts on the Bradford Group’s actual volumes that exceed the NSA’s negotiated volume thresholds (not the before-rates volumes) up to the volume cap, no matter what the cause of the volumes—whether discount induced or non-price exogenous factors.¹⁷ Where the actual volumes are caused by non-price exogenous factors, the Postal Service will not earn “new” contribution. In that case, the actual volumes above the NSA’s volume threshold would have occurred in any event since they were not caused by the discounts. The before-rates volume forecast is therefore irrelevant to the net contribution to the Postal Service.

B. The Postal Service Can Never Know Whether Volumes In Excess of NSA’s Thresholds are Induced by Discounts or Non-Price Exogenous Factors

The Postal Service will not be able to determine whether any increase in volume occurring during operation of the Bradford Group NSA (if approved) is caused by

¹⁷ Tr. 2/27 (OCA/USPS-T1-8(c)).

discounts, and therefore increases the net contribution to the Postal Service, or by non-price exogenous factors. Under the NSA, the Bradford Group will pay less postage on its actual volumes up to the volume cap, whether its actual volumes are induced by the discounts or caused by non-price exogenous factors.¹⁸ However, to increase contribution above what would be realized absent a NSA requires that “additional mail volume is caused by the incentive to mail additional volume (because of the mailer’s demand characteristics), and not because of exogenous factors.”¹⁹ Under such circumstances, while the Postal Service will earn additional contribution, that contribution will not be “new” to the extent that volume above the discount threshold is caused by non-price exogenous factors.²⁰

The Postal Service acknowledges that, “Once discounts intended to influence mailer behavior are established, it is not possible to ‘observe’ what mailer behavior would have been without such discounts.”²¹ While the Postal Service observes that it will be able to “track actual volumes” during the life of the NSA:²²

[i]t is likely that the Postal Service will *not* be able to distinguish volume changes caused by the other factors from those generated in response to the discounts. (Emphasis added)

The Postal Service also acknowledges that it does not “possess the data needed to quantify the uncertainty and variability of other non-price outside events for individual

¹⁸ Tr. 2/27 (OCA/USPS-T1-8(c)).

¹⁹ PRC Op. MC2004-3 (Bank One Opinion and Further Recommended Decision), para. 3006.

²⁰ Tr. 2/69 (OCA/USPS-T1-42(k)).

²¹ Tr. 2/36 (OCA/USPS-T1-16(a)-(b)), citing Docket No. MC2002-2, Tr. 4/767 (Response of Witness Plunkett to POIR No. 2, Question 5).

²² Tr. 2/26 (OCA/USPS-T1-7(a)); *see also* Tr. 2/54 (OCA/USPS-T1-32).

mailers (assuming the data for such an analysis exists).”²³ In fact, the Postal Service is unable retrospectively to use any of the data collected or developed in its proposed Data Collection Plan (DCP) to determine whether the Bradford Group’s actual volumes are induced by the NSA’s discounts or caused by exogenous factors.²⁴ Nor can the Postal Service use any of the data collected or developed in its DCP to determine whether any net contribution received during the pendency of the NSA “is the result of the Bradford Group’s actual letter-shaped and flat-shaped volumes induced by the NSA’s discounts rather than volumes caused by all other factors.”²⁵ In the final analysis, the Postal Service concludes that:²⁶

There is no Data Collection Plan that could be created that would allow the Postal Service to distinguish the volumes induced by discounts from volumes caused by all other factors.

Nevertheless, the Postal Service places great reliance on the possible use of risk-mitigating features written into the Bradford Group NSA. These risk-mitigating features are “intended to address the presence of risk by providing mechanisms to adjust for unforeseen circumstances and/or misestimations by either party.”²⁷ However, distinguishing between volumes induced by the discounts and volumes caused by non-price exogenous factors is a prerequisite to using the risk-mitigating features of the NSA. As discussed above, the Postal Service’s ability to distinguish price-induced

²³ *Id.*

²⁴ Tr. 2/31 (OCA/USPS-T1-12(a)).

²⁵ Tr. 2/31 (OCA/USPS-T1-12(b)).

²⁶ Tr. 2/32 (OCA/USPS-T1-13).

²⁷ Tr. 2/26 (OCA/USPS-T1-7(a)); *see also* Tr. 2/54 (OCA/USPS-T1-32).

volume increases from all other volume increases in “real time” is nonexistent, and therefore precludes it from using the risk-mitigating features of the NSA to adjust for unforeseen circumstances, such as increased volumes caused by exogenous factors, or simple errors in volume estimation.

III. THE POSTAL SERVICE CANNOT SHOW ANY ENHANCEMENTS TO POSTAL OPERATIONS OR ANY OTHER FINANCIAL BENEFITS THAT CAN JUSTIFY RECOMMENDATION OF THE BRADFORD GROUP NEGOTIATED SERVICE AGREEMENT

The Bradford Group NSA is described as “relatively simple” because it is “designed to provide incentives to Bradford Group to increase its use of Standard Mail letters and flats for the purpose of selling collectibles to a nationwide customer base.”²⁸ Based upon the Postal Service’s financial model, the sole source of potential additional contribution to the Postal Service that is quantified on this record is the increase in Standard Mail solicitation letter and flats volumes induced by the discounted rates.²⁹ The Bradford Group NSA does not provide any other quantified or unquantified benefits, such as improvements to the Postal Service’s operational performance, of the type that contributed to Commission approval of the Bank of America NSA. Moreover, merely increasing the volume of Standard Mail letters and flats cannot reasonably be expected to “enhance the performance of mail preparation, processing, transportation, or other functions.” In any event, no evidence or even claim has been advanced that these volumes would lead to that result. Consequently, the Postal Service makes no

²⁸ Testimony of witness Parr (USPS-T-1), at 1.

²⁹ Testimony of witness Parr (USPS-T-1), Appendix A; *see also* Tr. 2/35 (OCA/USPS-T1-15).

claim that the Bradford Group NSA would satisfy the PAEA's second statutory test and thereby justify Commission recommendation.

As a proposed functionally equivalent NSA to Bookspan, the Bradford Group offers-up an equivalent of Bookspan's "multiplier" effect. The Bradford Group's multiplier effect, presented in the testimony of witness Gustafson (BG-T-1),³⁰ is described as a consequence of its use of solicitation mail, which "contributes to the mailstream" by bolstering growth of the mail across all classes.³¹ However, like the Bookspan NSA, the financial benefits to the Postal Service of the Bradford Group's multiplier effect is not quantified on this record.

Unlike the Bookspan NSA, however, the Bradford Group NSA must be considered under the new statutory tests of the PAEA. Under the former Postal Reorganization Act, the Commission established "reasonable likelihood" of a net increase in contribution as the standard for approving NSAs.³² Consistent with the PAEA, the Commission proposed (and subsequently established) "must improve the net finances of the Postal Service" as the standard for approving NSAs.³³

Given that the Bradford Group NSA lacks any enhancements to postal operations and now "*must . . . [i]mprove the net financial position of the Postal*

³⁰ Testimony of witness Gustafson (BG-T-1), at 2-6.

³¹ *Id.*, at 3.

³² PRC Op. MC2004-3, (Bank One Opinion and Further Recommended Decision), para. 5010.

³³ Docket No. RM2007-1, Order No. 26, "Order Proposing Regulations to Establish a System of Ratemaking," (herein "Order No. 26"), at 38.

Service,”³⁴ the Commission must reject the Bradford Group NSA, as it fails to meet either statutory test established by the PAEA for approval of NSAs.

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³⁴ Docket No. RM2007-1, Order No. 43, “Order Establishing Regulations for Market Dominant and Competitive Products,” (herein “Order No. 43”), at 127, § 3010.40(a)(1) (emphasis added).

³⁵ Designated by the Commission to represent the interests of the general public. “Notice and Order in Filing of Request Seeking Recommendation of Functionally Equivalent Negotiated Service Agreement,” August 8, 2007.